Crash a boon to 1 strategy

By Fred Williams

Even though the rest of the stock market was in disarray, domestic securities lending programs produced up to 50% more income than usual during October and November because demand for available securities to cover short positions increased as the market dropped.

In addition, this low-risk way of generating incremental income became even safer during the market crash because the securities lent were overcollateralized.

George Ominski, principal with Capital Advisors Inc., a Lancaster Pa., investment management firm and one of the few non-bank securities lending firms, said income from securities lending programs probably jumped by "half as good again on a month-to-month basis. If they were getting 50 basis points, it was probable they jumped up to 75 basis points following the market action."

Many pension executives were unable to provide hard data on their securities lending programs, explaining there is a two- to three-month lag in receiving figures.

But Ray Fleming, administrator of the $604 million Dallas Employees' Retirement fund, said the fund netted about $15,000 from securities lending in October and November. That represents 37.5% of the $40,000 the fund has earned on the program so far this year.

The fund's program, which involves $20 million to $150 million worth of securities, is limited to U.S. government securities, which Mr. Fleming said are "easier to lend" in the current market environment.

Industry officials believe other pension funds experienced similar income increases from securities lending.

"I would be very surprised if they didn't see a significant spurt in earnings in the October and early November time period," said Nancy Wolcott, vice president for master trust and special services at Harris Trust & Savings Bank, Chicago. "Demand increased and the spreads were up as well, and the brokerage firms were willing to pay a little more in order to cover their positions."

Steven Cox, assistant vice president of DeMarche Associates, Kansas City, Mo., said custodian banks were able to generate additional income "because brokers needed to borrow additional securities to cover short sales at that time, and there probably was a jump in borrowing activity."

Securities lending is a byproduct of increased trading volume during the past 10 years; demand has increased for deliverable securities that are borrowed, for a fee, on a short-term basis. Securities lending transactions usually are handled by custodian banks, with the income split between the bank and the investor. Some pension funds find the returns offset master trust/custodial fees.

When securities are lent, the brokerage normally puts up 102% of the market value of the borrowed securities as collateral, either in cash or in government securities.

As the market value changes, the collateral is adjusted until the transaction is settled.

Because stocks declined dramatically in October, custodial banks found their securities lending programs overcollateralized, making a relatively safe investment technique even more secure, said Mr. Cox.

Cash collateral usually is invested by the custodial bank generating additional income for securities lending with a portion rebated to the brokerage firm. In October, as demand for lendable securities increased, the spreads on short-term money also increased. When the demand for securities jumped, brokerage firms were willing to take smaller rebates, leaving more for the lenders, said Mr. Cox.

As an additional security measure, he said, some bank trustees shifted collateral requirements to 100% cash.

"The only risk associated with it is if the brokerage firm happens to go under, which is a minor risk. Even if they do go under, we still hold 102% of the value of the security," said Louise Graham, vice president and director of master trust services at First RepublicBank Dallas. First Republic has about $12 billion of assets in its securities lending program.

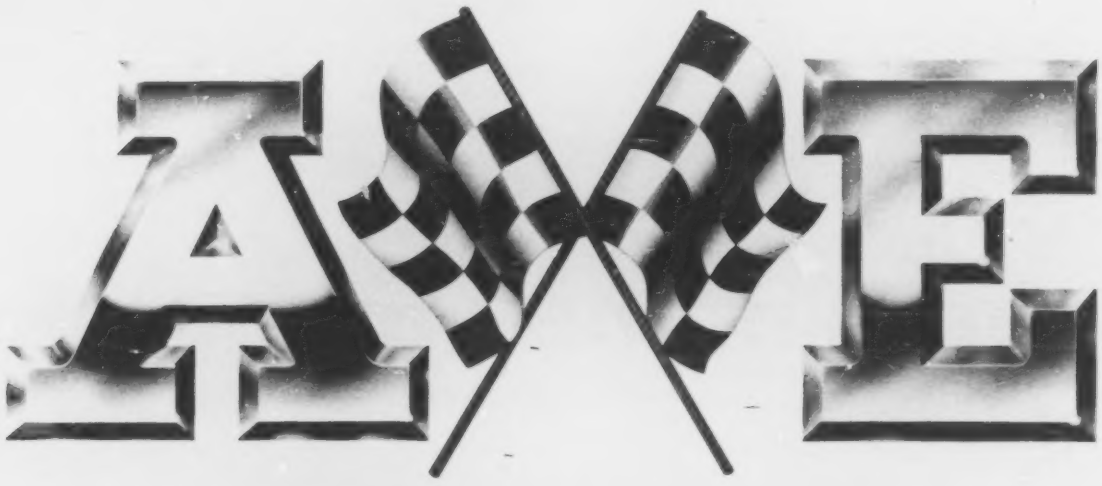
"It is not so much an incremental increase in our overall rate of return, as much as income to offset certain expenses of the fund," said Nathaniel Duffield, chairman of the profit-sharing committee at The Halliburton Co., Duncan, Okla.

Halliburton has hired First RepublicBank for a new securities lending program, which would involve $700 million of the company's $2 billion in employee benefit assets.

"We felt we could generate additional income for the fund at a reduced risk. We don't have a feel yet or an estimate for the type of income it will produce. It really depends on market conditions and on the supply and demand for securities as well as on the specific portfolio mix at the time the securities are loaned. But we felt it would generate enough income to be workable for us," he said. ■

Corrections & clarifications

- Because of a compilation error, the broad market index returns furnished by **Morgan Stanley Capital International** and reported Nov. 16 were in error. The World index was down 17.1% for October and the Europe Australia Far East index was down 14.1%. Individual market figures were correct.
- **Sunburst Bank** is based in Jackson, Miss. The location was misidentified in the Nov. 16 PIPER listings.
- The investment returns of **MTrust Austin**, Texas, were omitted inadvertently from the Nov. 16 PIPER listings. MTrust's growth fund was up 48.6% for the 12 months ended Sept. 30, ranking it in the top 10% for the period. For three years, it was up 29.5% compounded annually, and for five years it was up 25.5% compounded annually; both figures placed it in the top 25% for the periods.
- **Argus Investment Management Inc.**, Santa Barbara, Calif., which was acquired from Argus Research Group, has investment policy autonomy from Argus Research, although it retains the Argus name under a royalty agreement. The relationship was described incorrectly in the Nov. 16 issue.
- **Alan D. Lebowitz** has been named deputy assistant secretary of program operations of the Pension and Welfare Benefit Administration at the Department of Labor. His new title was reported incorrectly in the Nov. 30 issue.



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Earnings . . .

Continued from page 2

financial asset prices will narrow the earnings of many investment banking activities," the report said.

The universe of investment banks Mr. Goldstein studied includes Salomon Brothers Inc., Goldman, Sachs & Co., First Boston Corp., Morgan Stanley & Co., Bear Stearns & Co., Kidder Peabody Inc., Dillon, Read & Co. Inc., Lazard Freres, L.F. Rothschild and Wertheim & Co. It does not include Merrill Lynch, Drexel Burnham Lambert Inc., Shearson Lehman Brothers Inc. and Donaldson Lufkin & Jenrette.

The industry's difficulties also stem from the erosion of the level and structure of investment banking in the 1980s. Mr. Goldstein said profit margins have declined 20% to 30% and returns on equity have fallen to 15% from 30% on an equity base that has grown sevenfold. At the same time, the fixed component of expenses has grown to $4 billion from $800 million, increasing the industry's breakeven point fivefold.

"This substantial degradation in the economics of the industry is a direct result of the rising dominance of market-making," Mr. Goldstein's report said.

"The trading and arbitrage of debt and equity securities is now inextricably intertwined with corporate investment banking services. A major position in a wide range of secondary markets is needed to support not only primary issuance, but the reputation and image of the firms themselves."

All these factors will combine to exert enormous pressure on investment banking firm managers in coming years. In Mr. Goldstein's view, the end result is management will assume a greater degree of centralized control and shrink operations to focus on the areas where the firm is strongest.

Interest-rate sensitive businesses he said will be affected by the changing environment — including underwriting, mergers and acquisitions, leveraged buyouts and bridge financing — are the lines of business that contributed most to industry earnings in the past few years.

Despite anticipated cost reductions, the poor performance of these businesses will result in earnings declining 35% to 40% from the 1986 peak and a forecast 1991 trough, Mr. Goldstein predicts.

He expects industry earnings to drop about 15% in both 1987 and 1988, with moderate drops continuing through 1990. The investment banking group currently is valued at 6.5 to 8 times Mr. Goldstein's estimates for 1988 earnings.

A more severe drop is unlikely, he said, because most lines of business move with the credit cycle, some businesses are countercyclical and there is still room for cost cutting.

He said future performance of the major public investment banking firms primarily will be a function of revenue and profit mix and management skill.

His predictions for specific firms include:

- First Boston's earnings will be cyclical with higher interest rates, declining 15% in 1988 and an additional 12% to 15% in 1989. Trough earnings in 1990 should be 45% below 1986's peak levels with a 10% to 15% reduction in total expenses.
- Morgan Stanley's near term earnings also are expected to decline significantly off 1987's peak as bridge financing, related non-investment-grade debt underwriting opportunities and equity underwriting wane. Earnings will fall 20% to 25% in 1988 and an additional 10% in 1989 as interest rates rise and equity markets remain depressed. He expects continued strength in foreign exchange and commodities trading, a significant asset management business and a moderate rebound in debt trading profitability. Trough earnings in 1990 are expected to be 30% to 35% below 1987's peak, contingent on an 8% to 10% reduction in total expenses.
- Salomon Brothers, already hit by the emerging cycle in the industry, is likely to experience the least cyclicality going forward. Earnings should roughly double in 1988 and improve an additional

Continued on page 35

Large investment banks domestic profitability trends (1985 - 1992E)

	1985	1986	1987E	1988E	1989E	1990E	1991E	1992E
Gross income after inventory carry ($ bil.)	$6.8	$8.5	$8.4	$8.7	$8.5	$8.0	$10.0	$13.5
Pre-tax net income ($ bil.)	$1.8	$2.1	$1.5	$1.5	$1.4	$1.4	$2.2	$3.6
Pre-tax profit margin	26%	24%	18%	17%	16%	18%	22%	27%
Average shareholder's equity	$4.7	$6.2	$7.8	$8.7	$9.5	$10.4	$11.8	$13.9
After-tax return on average shareholder's equity	22%	20%	12%	12%	9%	9%	12%	17%

E - estimate
Source: FOCUS Database, Bernstein estimates

Allegis . . .

Continued from page 2

analysts to be a key component in financing the company's expansion plans.

Separate lawsuits filed by employee groups representing the pilots and flight attendants, however, delayed the reversions. Ultimately, the plans were not terminated.

The inability to recover the surplus pension assets forced company officials to turn to other financing means, including a $243 million issue of common stock during the fourth quarter of 1985.

The decision to forgo the terminations also meant the pension assets would have to be moved out of cash and re-invested in the financial markets.

By the end of September 1986, Mr. Dykstra had placed 44% of the then $1.6 billion defined benefit assets in the stock index fund, 44% in internally managed fixed-income instruments and 12% in real estate equity. ■

THE SWIFT. THE BRILLIANT.

Earnings . . .

Continued from page 34

20% in 1989 as the trading environment improves marginally, and appropriate trading strategies are effected. Earnings should remain essentially flat in 1989-'90 at a level 30% to 35% below the peaks of 1985-'86 as the firm is exposed to cyclical declines in debt underwriting and mortgage finance. Trough earnings 33% below 1985's peak assume a further 10% to 12% expense reduction.

"Investment bank earnings have historically been correlated with large movements in interest rates. It has not been debt trading alone that caused this sensitivity; rather, a wide and growing range of investment banking activities, such as debt issuance, are directly related to rates or are indirectly sensitive, like mergers and acquisitions," Mr. Goldstein's report said.

"We believe a continuance of the rising rate environment, and an associated moderate further decline in the equity markets, will have negative profit implications for underwriting activity, mergers and acquisitions and leveraged buy-out activity, as well as equity market-making profits. In addition, the mortgage finance business should also emerge as quite cyclical with the housing market."

He projects a $200 million pretax loss in 1987 for debt market-making, but looks for the business to recover next year.

"Even in the face of rising rates, debt market-making will recover in 1988-'89 to produce commodity-level rate of return. Trading strategies will be adjusted, and the secular trend toward rising turnover will continue, though at a slower rate," the report said. "We expect a recovery in 1988 that will produce a positive swing of $400 million, without which industry earnings would be down almost 30%."

He said underwriting, especially of debt, has peaked, and earnings from this line of business will drop sharply in 1988.

"We believe a cyclical slowdown in issuance in 1988 will lead to an earnings collapse in the fixed cost intensive underwriting business from $450 million to $500 million in 1987 to about $100 million in 1988. We expect profits to remain at this level in 1988-'89," the report said.

Mergers and acquisitions advisory and financing fees and risk arbitrage profits provided a third of the industry's profit growth in the past several years, Mr. Goldstein noted. He thinks the recent decline in the equity markets may prompt a "bubble in merger and acquisition activity to occur in the near term." But over the longer term, he believes higher interest rates will reduce the level of activity. His forecast is for overall transaction volume to decline to $160 billion in 1988 and $150 billion in 1989 from $180 billion this year. Earnings will fall to $570 million in 1988 and $400 million in 1988 from about $720 million in 1987.

During the next five years, market-making activities are expected to grow in importance relative to other investment banking activities. "The importance of market-making should be further exaggerated by a cyclical decline in underwriting and advisory activities," the report said. "Absent a success of a major new innovation, such as the emergence of a large market for less-developed-country debt or commercial bank loans, we believe the average rate of return from market-making will be limited to a level similar to that normally earned by commercial banks, thereby further reducing overall rates of return."

Historically, commercial banks have made, after tax, 12% to 13% return on equity, Mr. Goldstein said. ■

Large investment banks domestic profitability analysis (1985- 1992E)
(Percentage of total)

	1985	1986	1987E	1988E	1989E	1990E	1991E	1992E
Equity market-making and investment	5%	4%	1%	4%	1%	−4%	18%	14%
Debt market-making and arbitrage	23	7	−14	13	14	25	31	14
Other trading	9	8	12	15	22	28	20	12
TOTAL MARKET-MAKING CONTRIBUTION	38	19	−1	32	38	50	69	40
Underwriting	22	28	32	6	6	7	8	25
M&A and related income	37	40	48	37	29	18	3	13
Private placements/other advisory	9	15	12	12	10	11	6	9
TOTAL INVESTMENT BANKING CONTRIBUTION	68	83	91	56	45	36	16	48
Asset-based revenue	10	12	23	25	32	28	24	17
All other - net	−15	−14	−13	−13	−15	−14	−9	−5
Pre-tax broker/dealer income	100	100	100	100	100	100	100	100

E - estimate
Source: FOCUS Database, Bernstein estimates

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Pensions & Investment Age will profile the top 1,000 pension funds in the Jan. 25 issue

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Pensions & Investment Age

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Owens-Illinois sub offers mutual funds

By Marlene Givant

TOLEDO, Ohio — Owens-Illinois Inc.'s investment management subsidiary, Harbor Capital Advisors, will offer five new mutual funds to participants in Owens-Illinois' savings plans, plans of other companies and other outside investors.

The five funds will join Harbor's previous offering to form a family of mutual funds spanning several asset classes and investment styles, according to Ronald C. Boller, chairman and director of Harbor and director-benefit finance of Owens-Illinois.

The pioneer fund, Harbor Growth, was formed last December (*Pensions & Investment Age*, Dec. 22, 1986). So far, only 3% of the $100 million mutual fund's assets have come from outside in-

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Outlook:

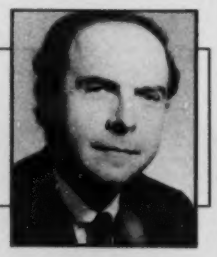
THE ECONOMY: What does 1988 hold? Good times or bad? New booms or new crashes? For the answers, *Pensions & Investment Age* goes to the experts. Their views in a nutshell are offered below; the story is inside — Page 3.

"IT'S AN ELECTION YEAR and I think efforts will be made to keep interest rates down."

Robert Chandross

"WHAT THE MARKETS really are looking for is some discipline from Congress."

David Littman



"THE ODDS (OF A RECESSION) are 50-50. . . . The conditions in the financial markets could well precipitate a recession."

Robert Dederick

"NEVER UNDERESTIMATE what a politician will do in an election year."

Thom Brown

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Budget details pummel funds

By Nicky Robertshaw and Joel Chernoff

WASHINGTON — The budget reconciliation law passed by Congress last week hit defined benefit plans with a double whammy, raising costs for employers and increasing the year-to-year variability of pension fund contributions.

The law, signed by President Reagan Dec. 22, tightened minimum and maximum funding rules, increased the annual premium employers must pay to the Pension Benefit Guaranty Corp. to between $16 and $50 per participant from a flat $8.50, and reduced the period over which past-service liabilities and experience losses in pension funds can be amortized.

The legislation, however, lacks key provisions that would have allowed employers to recoup surplus pension assets without terminating their plans; it also is missing provisions requiring a portion of the surplus to be allocated to plan participants.

The legislation has its greatest impact on sponsors of poorly funded defined benefit plans. It increased pension contributions, premium payments and potential liability to the PBGC and plan participants. It also may affect their creditworthiness.

But the legislation will hit all employers, such as those who flip in and out of the narrowed minimum and maximum funding ranges.

The new funding rules are creating a "Goldilocks effect," explained Henry Savath, vice president at A. Foster Higgins Co., the employee benefit unit of Johnson & Higgins, New York. "It can't be too great, it can't be too little, it has to be just right."

Many of the details of the rules were not available at press time. But major provisions are:

- Tougher minimum funding rules will accelerate funding for some employers. Past-service liabilities will have to be funded within 18 years, instead of the current 30 years. Also, experience gains and losses will have to be amortized during five years, instead of the current 15 years. Faster funding rules will apply to underfunded plans.
- Employers will lose deductibility for contributions when funding exceeds 150% of termination liability. The Internal Revenue Service, however, is required to issue regulations altering the limit for employers whose funding would be distorted by such a rigid limit, such as those with very young work forces whose permissible contributions would be sharply reduced under the 150% rule.
- Employers will have to make quarterly payments on their pension contributions; current rules give companies up to 8½ months after the end of the plan year. Estimated payments will be made when the actual contribution has not yet been determined.
- The number and the availability of funding waivers to employers will be limited and amortization of the waived payment will be spread over five years rather than 15 years as now required.
- The ability to terminate an underfunded plan will be further restricted. Under legislation passed in 1986, an employer could dump its underfunded plans on the PBGC under several conditions, including a filing under federal bankruptcy code. Now, the employer also will have to prove financial hardship or meet other criteria. Also, employers terminating underfunded plans

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LDC debt's fallout

Banks' woes could hurt asset-backed ratings

By Jacqueline Dutton

A new wave of concern over the health of U.S. banks burdened by Third World debt is threatening to knock billions of dollars worth of asset-backed securities supported by those banks down the ratings ladder.

The ability of the banks to ensure payment on pools of asset-backed securities is being challenged by Moody's Investors Service Inc., New York, which recently placed more than $6 billion of investment-grade, asset-backed securities on its "structured-finance watchlist" for possible downgrading.

As a result, institutional investors, who are big buyers of asset-backed securities, may feel compelled to unload those issues and may have to pay more for high-quality issues to replenish their portfolios. Many institutional investors are barred from investing in anything but the highest quality issues.

William F. Quinn, assistant treasurer at American Airlines, Fort Worth, Texas, said the value and risk characteristics of the underlying securities and issuers of securities are most important in rating the quality of asset-backed securities.

But Mr. Quinn said a downgrading caused by the banks that support the securities could force him to sell the $3.2 billion fund's $100 million in mortgage-backed securities if the ratings fell below investment grade.

He noted the secondary market for "fallen angels" is weak. He also warned wholesale downgrading of structured financings backed by banks exposed to LDC debt could mean higher prices for investment-grade issues.

But David Bronner, chief executive officer of the $6 billion Retirement Systems of Alabama, Montgomery, said a bank credit-related downgrading would do little damage to the high-quality, low-risk type of mortgage-backed securities portfolio managed by his staff. Mr. Bronner could not break out the amount his fund held in mortgage-backed securities.

Mr. Bronner said for a highly diversified, long-term portfolio, the banks' role as an insurer is not as important as it is for a new issue upon which little principal has been paid.

He said if the credit-providing bank "hit the wall" because of LDC debt, the effect on the quality of a four- to seven-year pool with a high loan-to-value ratio would be minimal.

Issuers of asset-backed securities say the potential downgrades undermine the market for otherwise low-risk investment pools, and as a result they

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Firms shielding cash portfolios

By Chuck Paustian

Confronted with an uncertain economy, companies with large cash reserves continue to play it safe.

And those that do take advantage of the vast size of the cash portfolios — using a portion of their portfolios for higher-yielding instruments and turning to outside investment firms — may return to the safe harbors of more traditional investments after recent market volatility.

Significant amounts of surplus corporate cash present a financial executive with two options — use the cash to meet the company's capital needs and curtail external financings or keep the funds as a reserve and continue to pursue borrowing opportunities.

As a result, corporate executives attempt to preserve this maneuverability, often being willing to forgo enhanced performance in favor of safe, liquid investment vehicles, such as domestic commercial paper, bankers acceptances, Treasury bills and certificates of deposit. The investments usually are managed internally.

When Chicago-based Amoco Corp. decided to repurchase some of its stock, company officials decided to draw the necessary funds from the corporate coffers rather than further leveraging the company by borrowing, according to John J. Murray, director of short-term investing and borrowing.

Amoco has purchased 34.6 million shares of stock at a total cost of $2.043 billion. As of Sept. 30, the company's cash and short-term investments totaled $1.361 billion, up from $772 million a year earlier.

American Telephone & Telegraph Co., New York, has been able to curtail some of its financings, having amassed a cash position of $2.91 billion as of Sept. 30, the result of strong cash flows during the past several years.

David W. Reiss, corporate assistant treasurer, said the cash position "permits the company to go into the markets when it wants to, rather than being forced into it," he added.

Mr. Reiss added AT&T does maintain a presence in the market through a commercial paper program, which ranges between $200 million and $400 million.

T.P. Townsend, an assistant treasurer at Exxon Corp., New York, said the company's $3.02 billion cash position allows company executives to be more selective in its financing.

"At the time we had $3 billion in cash, we were borrowing both short- and long-term all around the world," he said. "As an attractive opportunity comes along, we'll borrow and maybe repay some more expensive borrowings.

"We continually look for opportunities and actively manage the debt," he added.

James Lyness, manager-market strategy and cash forecasting at Chevron Corp., San Francisco, said the company uses a similar strategy. While Chevron's $3.556 billion cash portfolio is used to service the company's debt, executives are constantly looking for more attractive opportunities.

"If you saw interest rates rising, you might do some swaps or term financing to lock in the current rates and not have to pay higher rates six months from now," Mr. Lyness said.

He added the cash also serves as a hedge against rising interest rates for Chevron's floating-rate debt, much of which was incurred as a result of the merger with Gulf Oil Corp. He said enhanced in-

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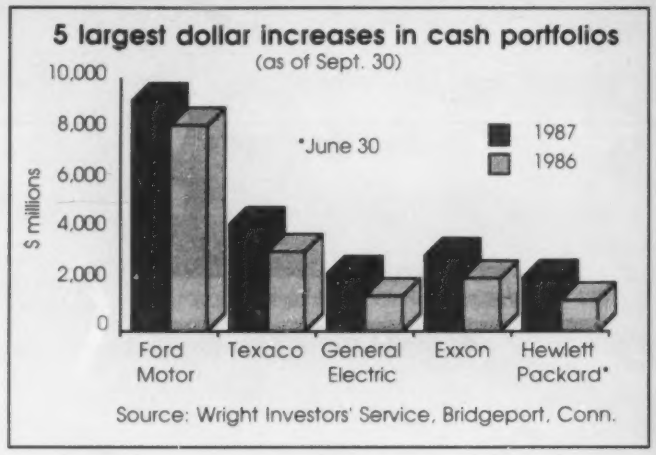

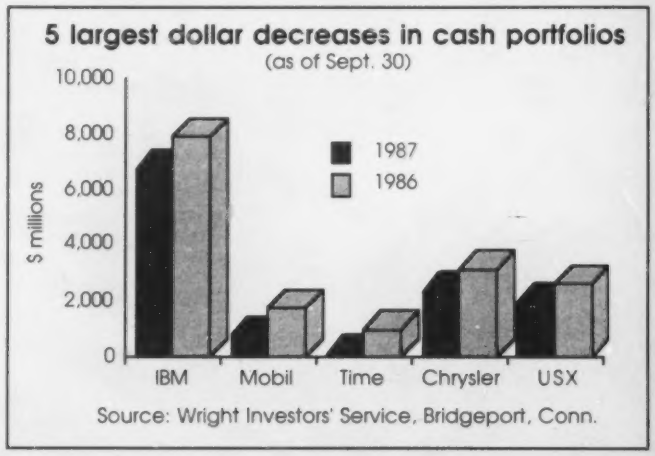

Plans boost real estate capabilities

By John Covaleski

As pension fund investments in real estate have grown, so too has their executives' involvement in real estate investment decision-making.

Although several dozen pension funds have one or more specialized real estate investment staff members to oversee the fund's outside real estate managers, some are creating internal real estate operations that analyze deals brought to them by outside managers or, in a few cases, find and make the deals themselves.

Real estate

Among the leaders:

- The pension fund of General Electric Co., Stamford, Conn., is the grandaddy of internal real estate departments. Operating since 1953, the 10-person staff is responsible for a $3 billion real estate portfolio, about evenly divided between solely owned properties and partnerships with developers and other investors. No outside managers are used.
- A 20-member staff at the State Teachers Retirement System of Ohio, Columbus, seeks and closes on property either co-invested with other pension funds or acquired solely by the fund. Ohio Teachers, which has $1.3 billion in real estate, also has some money in commingled real estate pools for diversification.
- Tom Hassard, real estate investment director and sole real estate staff member of the Virginia Supplemental Retirement System, Richmond, analyzes deals from non-discretionary managers and has begun entering the fund into its own development deals. He now is soliciting construction bids for the fund's first independent project, a $6 million parking garage.
- The staff at American Information Technologies Corp., Chicago, with $700 million in real estate, seeks and structures its own deals, primarily as joint ventures with developers or in co-investments with other pension funds. It also does a full internal analysis of deals brought in by managers. Tom Thompson, director of real estate investments, works on the fund full time and uses the services of the fund's analysts.
- The three-person staff of the Florida State Board of Administration, Tallahassee, reviews all proposals from its managers, who do not have discretion. The board has $650 million in real estate.
- Until this year, the five-member real estate department at the Wisconsin Investment Board, Madison, had been charged with finding its own investments for its $350 million real estate portfolio. Now, the staff analyzes and oversees investments from managers hired on a non-discretionary basis.
- The five-member staff at the California State Teachers' Retirement System, Sacramento, analyzes the deals of managers without discretion.

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State funds mortgages

By John Covaleski

HARTFORD, Conn. — The $5.3 billion State of Connecticut Trust Funds will invest $800 million in commercial mortgage loans during the next five years in what could be the first step in a trend of pension funds moving more heavily into commercial mortgage lending.

David Hartzell, a vice president of real estate research at Salomon Brothers Inc., New York, said a large-scale pension fund movement into commercial mortgages is expected because real estate debt has been outperforming real estate equity and because commercial mortgages, if structured correctly, provide added diversification and a safe yield.

Specific figures comparing the performance of real estate debt to real estate equity were not available, but preliminary findings of a report show superior debt performance, Mr. Hartzell said.

Assets for the commercial mortgage loans will come from the Connecticut funds' fixed-income portfolio, which as of Oct. 31 accounted for 39% of total assets, or $2.1 billion. The fund is looking for mortgages of five to 10 years with yields 100 to 120 basis points higher than Treasury bills of the same maturity, said Robert A. Staley, investment officer-real estate.

This action represents the fund's first investment in commercial mortgage lending. It has, however, originated mortgages on in-state residential property and has about 1% of its assets, or $53 million, invested in mortgage-backed securities issued by the Government National Mortgage Association and the Federal Home Loan Mortgage Corp.

Mr. Staley said his fund may be interested in ultimately packaging and selling parts of the commercial mortgage portfolio it builds. In March, the fund issued $252 million in collateralized mortgage obligations from its in-state residential mortgage portfolio (*Pensions & Investment Age*, April 6).

Connecticut's commercial mortgage fund will consist primarily of fixed-rate mortgages without ratings, but could include participating mortgages if the participation does not exceed 50% of the property's cash flow, Mr. Staley said. Mortgages with more than 50% participation would be considered part of the fund's real estate equity portfolio, he said.

The commercial mortgage portfolio will represent about 10% of the Connecticut fund's total assets by the time it's fully funded.

Investment managers hired for the portfolio also will have property management ability in case of problems with payments, Mr. Staley said. "We will not lend on any properties that we wouldn't want to own," he added.

The portfolio's first mortgage has been closed on an undisclosed Phoenix, Ariz., property in a deal arranged by Aldrich, Eastman & Waltch, Boston.

Rosalie J. Wolf, principal at Aldrich, Eastman & Waltch, said

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